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Regional Cooperation on Tax Issues: An Asian Agenda

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Abstract

The opportunities for regional cooperation on tax issues are significantly restricted by the unwillingness of national governments to give up their discretionary powers to determine the key elements of their tax systems. As a consequence, national governments have tended to compete more than they cooperate on tax matters, especially on tax matters affecting multinational business enterprises.

In some instances, however, regional cooperation is increasingly recognized as indispensable to fair and effective tax administration. This essay outlines three major areas in which Asian regional cooperation is becoming critically important to the proper functioning of national tax systems. The three areas are: (i) allocation of income of multinational enterprises in general; (ii) allocation of income from special industries with highly fragmented operations, such as shipping and air transport operations and satellite communication services; and (iii) taxation of E commerce. The conclusion of the essay describes some specific ways in which Asian tax administrations might cooperate to improve the fairness and effectiveness of their tax systems.

Introduction.

In theory, the opportunities for regional cooperation on tax issues are almost limitless. For example, national governments often talk about improving the climate for investors and, as the World Bank's report **Doing Business in 2005** makes clear,¹ simplification of the relationship between business and government can be a powerful stimulus for investment. Complex, opaque and heterogeneous tax procedures certainly must be close to the top of the list of unnecessary obstacles to investment, so what better way to attract domestic and foreign investment and improve the profitability of business

¹ World Bank, **Doing Business in 2005** (October, 2004).

activities than through regional harmonization of non-essential elements of national tax regimes and tax procedures?²

Unfortunately, the reality is quite different as the opportunities for regional cooperation on tax matters are significantly restricted by the unwillingness of national political leaders to give up their discretionary powers to determine the key elements of their tax systems. As a consequence, national governments have tended to compete more than they cooperate on tax matters, especially on tax matters affecting multinational business enterprises. In some instances, however, regional cooperation is increasingly recognized as indispensable to fair and effective tax administration. This essay outlines three major areas in which Asian regional cooperation is becoming critically important to the proper functioning of national tax systems. The three areas are: (i) allocation of income of multinational enterprises in general; (ii) allocation of income from special industries with highly fragmented operations, such as shipping and air transport operations and satellite communication services; and (iii) taxation of E commerce. The conclusion of the essay describes some specific ways in which Asian tax administrations might cooperate to improve the fairness and effectiveness of their tax systems.

² In national income tax systems, many of the tax rules and procedures could be harmonized without compromising on basic policy decisions. Some examples are:

- The tax year, due date of tax returns, statute of limitations for deficiency assessments, and times for claiming refunds could be harmonized without jeopardy to fundamental tax policy determinations.
- The penalties for not filing or late filing of tax returns, the non-payment and underpayment of taxes, tax negligence, tax fraud, and the responsibilities and liabilities of tax advisors all could be harmonized.
- The distinction between long and short term capital gains is usually based on a holding period ranging from 6 months to 2 years. This could be harmonized at 12 months or some other commonly accepted period without damaging national tax policies.
- The taxation of non-taxation of peripheral economic benefits, such as fringe benefits, also could significantly simplify the tax reporting obligations of multi-jurisdictional enterprises.

1. Allocation of income of multinational enterprises.

Allocating income among the various parts of multinational enterprises is both the most important and the most vexing issue in international taxation today. It is the most important issue because the globalization of economic activities has resulted in an enormous fragmentation in complex business activities such that now more than 60 percent of world trade takes place within multinational enterprises ("MNEs").³ As a consequence, income allocations among the various jurisdictions in which MNEs operate have major fiscal consequences for the national tax administrations. For MNEs, income allocations are important because they raise the risk that inconsistent allocations by national tax administrations will result in double or treble taxation of their profits.

At the same time, income allocations are the most vexing issue in international taxation because while there is widespread agreement on the use of the arm's length standard to determine transfer prices, which then result in allocations of income, the arm's length standard itself has very serious shortcomings. In fact, in some significant instances, the arm's length standard is so at odds with the reality of the transaction as to make it unworkable. In the case of transfers of patent rights between parent and subsidiary companies, for example, the arm's length standard, which seeks to replicate the open market price for the patent rights, seems particularly inappropriate because the patent rights are themselves unique and all transfers of such rights are between related enterprises. In such cases, there is no open market price and efforts to reconstruct such a

³ See **OECD Observer**, *Transfer pricing: Keeping it at arm's length* at www.oecdobserver.org/news/printpage.php/aid/670/Transfer_p (visited May 2, 2005).

price are so cumbersome and expensive and results so arbitrary that the parties often give up and conclude the dispute with a negotiated settlement.

Regional cooperation on income allocation is critically important for the following reasons:

- There is evidence that the more economically powerful countries are using the threat of rigorous transfer pricing administration to encourage MNEs to shift income to them and away from countries with more relaxed standards on income allocation issues.⁴ It appears, for example, that a U.S. based MNE with operations in Thailand will be mindful of the aggressive transfer pricing administration in the U.S. and less rigorous practices in Thailand. Because transfer pricing disputes are so time consuming and expensive, the MNE will adjust the transfer prices between the U.S. and Thailand so as to minimize the risk of any dispute. This means, of course, increasing the income arising in the U.S. and reducing the income arising in Thailand. In this environment of competitive transfer pricing administration, the Asian countries need to agree to a region wide effort to combat abusive practices in income allocations to preserve a reasonable proportion of the revenues from international business. This is best done collectively so as to diffuse the criticism from business groups that one country in particular has become anti-business because of its adoption of more rigorous income allocation procedures.
- In spite of its shortcomings, the arm's length standard is the most widely accepted international standard for allocating income of MNEs. The arm's length guidelines, however, are difficult to understand and even more difficult (and

⁴ See Irish, *The Other Harmful Tax Competition*, 24 **Tax Notes International** 901 (2001).

sometimes impossible) to administer. Very often in the Asian region, national tax administrations need help in training their officials in applications of the arm's length standard. Efficient use of training resources also suggests that the procedures for implementing the guidelines be harmonized among the Asian region.

- Because the arm's length standard is so deeply entrenched in the prototypical international tax regime, development of more realistic alternatives to deal with increasingly fragmented business operations is best done in a regional forum not dominated by MNEs or capital exporting countries. ASEAN and the Asian Development Bank, for example, could be excellent places to study the feasibility of broader use of formula apportionment in place of the arm's length standard. They also could provide excellent platforms for the study, development and implementation of symmetrical income tax systems to curb abusive income allocations by diminishing the tax benefits associated with such allocation.
- To take into account the legitimate interests of MNEs in avoiding double taxation through inconsistent income allocations, the Asian countries should agree to a harmonization of procedures on income allocation issues. They also should agree to cooperate in the use of correlative adjustment procedures when one country makes an income allocation adjustment.

2. Allocation of income from special industries with highly fragmented operations.

Shipping and air transport operations, satellite communications services, and international oil and gas pipelines are some examples of highly fragmented international

business activities. These activities present three distinct challenges for national tax administrators:

- First, many of the local components of the highly fragmented businesses are essential elements in the domestic economies. As a consequence, it is important that the national tax regimes not create barriers to conducting such businesses. Harmonious tax regimes developed at a regional level are much less likely to be viewed as disruptive than multiple schemes to tax the fragmented business enterprises.
- Second, the growing importance and the heightened visibility of the highly fragmented businesses mean that their potential as a source of revenue for the national governments cannot be ignored. Fairness to more pedestrian and localized business activities also dictate that the fragmented business operations be subject to roughly the same taxes as the localized business operations. Under current practices, however, source based taxes of highly fragmented businesses are quite few, with the default taxes imposed by the residence countries. Shipping and air transport operations, for example, are commonly exempted from income taxes in the source countries and only subject to tax in their countries of residence. Similarly, in the case of satellite communications services provided by U.S. companies, the U.S. tax rules allocate half of the income to U.S. source just because of the residency of the companies.⁵ As a consequence, to preserve their revenue bases, Asian countries need to develop fair and inclusive tax regimes to apply to the fragmented business activities.

⁵ U.S. Internal Revenue Code of 1986 (as amended) §863(e).

- Third, with multiple jurisdictions seeking to collect taxes from the fragmented business activities, the risk of double or multiple taxation increases. Regional harmonization of tax regimes coupled with regional cooperation in resolving tax disputes can greatly diminish the risk of double or multiple taxation.

3. Taxation of E commerce.

E commerce refers to a broad range of transactions in which some portion of the transaction is conducted electronically. For most Asian tax administrations, the increasing popularity of E commerce poses growing threats to the collection of both value added taxes (VATs") and income taxes.

A. VAT and E commerce.

By far, the largest form of E commerce involves B2B transactions in which the ordering is done electronically.⁶ From the point of view of VAT collection, these transactions do not pose a significant threat to the revenue base for two reasons.⁷ First, because the purchaser in B2B transactions is a business, the purchased good or service is likely to be incorporated into a finished product which itself will be subject to the VAT. The failure to impose VAT on B2B transaction usually means that the VAT collection is delayed but not avoided entirely. Second, most B2B transactions involve the physical delivery of goods, so as the goods enter the destination country the VAT can be collected as part of the customs clearance procedures.

⁶ The U.S. Government first published complete data on E commerce in 1999. Between 1999 and 2001, E commerce in the U.S. grew from \$660 billion to over \$1 trillion. 93 percent of the total E commerce involved B2B transactions for manufacturing shipments and wholesale trade sales. *See* U.S. Congressional Budget Office, **Economic Issues in Taxing Internet and Mail-Order Sales** (hereafter referred to as "CBO Study") at pp. 10 – 11 at www.cbo.gov/showdoc.cfm?index=4638&sequence=0 (visited December 30, 2004).

⁷ Ligthart, *supra* note 11, at pp. 5 – 6.

Where E commerce represents a threat to the VAT base is where the entire transactions occur electronically. Although totally electronic sales of intangible products are only a small part of E commerce,⁸ they present serious difficulties in VAT administration. VAT and other consumption taxes typically have been imposed on the purchase of physical goods and services and the tangible presence of the goods and services offers the VAT collectors a relatively easy taxable event on which to focus the collection process. Where entire transactions are conducted electronically, however, there is no physical presence, national boundaries are not relevant, and the VAT collector has no base for knowing that such transactions have taken place. In addition, current VAT collection puts heavy emphasis on a paper trail documenting transactions, but completely electronic sales usually do not produce any paper records.

Throughout the world, including the Asian economies, the rise of pure E commerce threatens VAT collection. Some have referred to VAT compliance as "roadkill on the information superhighway."⁹ Even though the imposition of VAT on E commerce transactions faces serious (and, as yet, unresolved) obstacles, it is important to confront these obstacles for at least the following reasons:

- The de facto exemption of E commerce transactions is likely to give rise to serious distortions in international economic behavior. Without regard for the underlying merits of an investment, E commerce will gravitate to low tax jurisdictions offering easy access to the lucrative markets in Asia, Europe, and the

⁸ It is estimated that in 2001 digital sales of intangible products in the U.S. and Europe accounted for 5 percent and 3 percent, respectively, of total E commerce transactions. Still, that proportion is likely to grow rapidly as countries develop and become more integrated into the global economy. *Id.* at p. 7.

⁹ *Id.* at p. 8.

Americas. Just in terms of economic efficiency, the exemption of E commerce transactions will be wasteful.

- More importantly, however, the de facto exemption of E commerce transactions discriminates in favor of a virtual presence in the destination country and against those enterprises with a physical presence (the "bricks and mortar" enterprises) within the destination country. And yet, the bricks and mortar presence often manifests itself in terms of increased employment opportunities, an expanded income and property tax base, and community outreach. Within many local communities, for example, the presence of a bricks and mortar bookstore creates employment even as it adds to the local income tax and property tax base. In addition, in local literacy campaigns, the virtual presence of Amazon.com and the other online booksellers contribute nothing while the local bricks and mortar bookstore very often plays a prominent role.¹⁰
- As E commerce grows, the revenue importance of extending VAT to E commerce transactions also will increase. As a consequence, even without regard for economic efficiencies and tax equity concerns and just for the sake of maintaining the revenue base, the Asian countries will need to find a way to bring E commerce transactions within the VAT base.

The European Union has the most extensive and sophisticated history with VAT administration and yet it has not developed an effective mechanism to collect VAT from nonresident vendors of intangible goods and services in purely electronic transactions. As a result, even in the European Union, the electronic delivery of music, software, movies,

¹⁰ American Booksellers Association, **Bookselling This Week**, *Sales Tax Initiative: Articles of Interest* at http://news.bookweb.org/m-bin/by_topic?topic_id=45 (visited May 18, 2005).

games and other intangible goods and services by nonresident vendors depends heavily on the voluntary compliance of the vendors for collection of the VAT.¹¹

The current evidence makes clear that the nettlesome problem of VAT collection on E commerce transactions cannot be dealt with effectively on a purely national level. Even at the regional level, no workable solutions have emerged, although it is likely that regional cooperation on VAT collection offers greater hope than any single national initiative.

B. Income tax and E commerce.

As with the VAT, income tax administration is heavily dependent on the physical presence of the taxpayer or the taxable event. Paper trails also are extremely useful in enforcing the income tax.

Income from the sale of goods or provision of services is most commonly taxed in the source country only when the vendor or service provider has a fixed and continuous place of business in the source country. The fixed and continuous place of business is referred to in international taxation as a "permanent establishment" and the international norm is to limit income taxes at source to the income properly attributable to a permanent establishment. Most countries in Asia adhere to this norm in the taxation of international income.¹²

The permanent establishment concept imposes major constraints on source based taxes of income from E commerce. As with VAT administration, where the E commerce anticipates delivery of tangible goods or the provision of tangible services, income tax collectors are able to apply the traditional notion of a permanent establishment without

¹¹ *Id.* at pp. 17 – 18.

¹² *See* Article 2(5) of the Indonesian Income Tax Law No.7/1983 (as amended, including the Third Amendment, Law No. 17/2000).

serious risks of non-compliance. In the case of pure electronic transactions, however, there is no physical presence in the source country and tax collectors have no way of knowing that a taxable event has occurred. They also do not know who or where the vendor or service provider is. As a result, pure E commerce transactions commonly escape income taxation in the source country, with the only income taxes collected in the residence country of the vendor or service provider.

Notice that in the case of pure E commerce transactions involving the online delivery of music, software, movies, games, books and other intangible goods and services, the countries in Asia are more likely to be the source country¹³ and the U.S., as the world's largest exporter of E commerce, is likely to be the residence country. Thus, in E commerce transactions involving most of the Asian countries and the U.S., the U.S. collects the bulk of the income tax revenues, with little or nothing going to the Asian tax collectors.

Unlike VAT collection on E commerce, some Asian countries have developed income tax regimes that deal somewhat effectively with source taxation of many E commerce transactions. The solutions are largely based on expanded withholding taxes to counter the deficiencies of the permanent establishment concept. These solutions, however, tend to be unpopular with the international business community and would be better accepted if they were discussed and formulated in a regional forum with participation by national tax administrators, E commerce industries, and the competitors of E commerce.

4. Regional cooperation on tax issues – some suggestions.

¹³ India is a notable exception as its high technology and entertainment exports flourish in Asia, Western Europe and North America.

The opportunities for Asian regional cooperation on tax issues are legion. Asian regional cooperation also is becoming critically important to the effective administration of key elements of national tax laws. Listed below are specific topics that are especially suitable for regional cooperation in the Asian region:

- An Asian regional conference and training seminar on the allocation of income for income tax purposes. The program could have at least three distinct components:
 1. Tax administrators typically allocate income by establishing transfer prices on intra-firm transfers using the arm's length standard. Because of the universality of the arm's length standard and its exceptional complexity when applied to many transactions common in today's fragmented production and service processes, many Asian tax administrations are largely incapable of using the arm's length standard to curb abusive transfer pricing practices. This inability often has both serious revenue and tax equity implications. Therefore, there is a continuing need for advanced training in transfer pricing procedures using the arm's length standard.
 2. Some Asian tax administrations have adopted procedures for the conclusion of advanced pricing agreements ("APAs") with MNEs.¹⁴ Under an APA, the tax collector and the taxpayer negotiate and then agree in advance to the transfer prices to be used to calculate the taxable income in that jurisdiction. Bilateral and multilateral APAs, involving the taxpayer and two or more tax jurisdictions, can be especially effective at assuring a

¹⁴ Korea, China and Japan, among others, have established procedures for advanced pricing agreements.

fair division of the tax revenues from the taxpayer's international business operations, improved tax compliance, and a reduced threat to the taxpayer of double or multiple taxation.

3. Although the arm's length standard is widely recognized as the international norm, it has many critics who advocate more workable alternatives to the arm's length standard. The most commonly discussed alternative is formula apportionment under which income is allocated among various jurisdictions according to relative intensity of the economic activities within the jurisdictions. Economic intensity is most commonly measured by sales, labor, and investment in the jurisdictions. Although formula apportionment is the principal standard used to allocate income among the various states within the United States, and it is commonly used to allocate income between a permanent establishment and the home office in international taxation, the international business community with support from many capital exporting countries is very hostile to wider adoption of the formula apportionment standard. Nevertheless, it, along with other alternatives (such as the U.S. "commensurate with income" standard and the development of symmetrical income tax systems to diminish the tax differentials which often drive abusive transfer pricing practices), should be discussed within a regional forum not dominated by MNEs or capital exporting countries.

- An Asian regional conference on source based income taxation of shipping and air transport operations, satellite communications services, international oil and natural gas pipelines, and other highly fragmented business activities. The systems currently in use for taxing the income of highly fragmented business activities generally focus on eliminating the risk of multiple taxation by giving the exclusive power to tax to the country where the fragmented business is resident. Source based taxes are generally prohibited. Such systems, of course, discriminate in favor of the more industrialized countries which are more likely to be the residence country than the less developed countries. An Asian regional conference focused on the development of feasible systems for source based taxation of fragmented businesses could help prevent erosion of the revenue base of the Asian countries as such fragmentation becomes more common. Any new systems will have to pay careful attention to the risks of double or multiple taxation, and regional harmonization of the systems should be sought, but the underlying goal should be more effective source based taxation of highly fragmented businesses.
- A conference on VAT collection and E commerce. Here the Asian region would benefit from the experience of the European Union so it may be attractive for the Asian region to team with either the EU or some EU member states to attempt to resolve this difficult issue. State tax administrators within the U.S. also may be helpful. Although the United States does not have a national VAT or any other comprehensive consumption tax, within many of the individual states of the U.S., single stage sales taxes are important revenue sources. As a result, there is an

ongoing debate within the U.S. on how to extend the state sales taxes to E commerce transactions originating outside the state.¹⁵ There are many state tax administrators within the U.S. with concerns that parallel the tax administrators in Asia.

- An Asian regional conference on source based income taxes and E commerce. The focus of this conference would be on formulating alternatives to the permanent establishment concept to deal with the absence of a physical presence in purely E commerce transactions. Although it still does not deal with E commerce transactions involving personal consumption (i.e., the digital downloading of music or other entertainment for personal use), one promising alternative is to expand withholding taxes on outbound remittances. In some jurisdictions, for example, a withholding tax is imposed on any outbound remittance that is the object of an income tax deduction by the payer.

One remaining question is the proper forum for Asian regional tax conferences. Given that some of the ideas mentioned above would be better discussed in an environment not dominated by the capital exporting countries, it seems that the ASEAN Secretariat would be more suitable than APEC/ The ADB also might be a suitable forum, although Japan and Korea are more likely to side with the fiscal position of the more industrialized rather than the less industrialized countries. Such a conference also could be hosted at the initiative a one Asian tax jurisdiction. In April, 2001, for example, the ROC Ministry of Finance hosted (with the University of Wisconsin's East Asian Legal Studies Center as the co-host) a regional conference on transfer pricing for tax

¹⁵ See <http://news.bookweb.org/news/3459.html> (visited May 18, 2005).

administrators and business leaders from the East and Southeast Asian regions. That conference might serve as a model for similar conferences and training seminars in the future.